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Proposed statement of position : Software revenue recognition (To supersede SOP 91-1, software revenue recognition); Software revenue recognition (To supersede SOP 91-1, software revenue recognition); Exposure draft (American Institute of Certified Public Accountants), 1996, June 14

American Institute of Certified Public Accountants. Software Revenue Recognition Working Group

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**EXPOSURE DRAFT**

**PROPOSED STATEMENT OF POSITION**

**SOFTWARE REVENUE RECOGNITION**

**(To Supersede SOP 91-1, *Software Revenue Recognition*)**

**June 14, 1996**

**Prepared by the Software Revenue Recognition Working Group  
Accounting Standards  
American Institute of Certified Public Accountants**

**Comments should be received by October 14, 1996, and addressed to  
Richard Stuart, Technical Manager  
Accounting Standards, File 2354  
AICPA, 1211 Avenue of the Americas, New York, NY 10036-8775  
or via the Internet to RSTUART @ AICPA.ORG**

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June 14, 1996

Accompanying this letter is an exposure draft of a proposed statement of position (SOP), *Software Revenue Recognition*, that would supersede SOP 91-1 of the same name. A summary of the significant provisions of the proposed SOP is included in the forepart of that document.

The purpose of the exposure draft is to solicit comments from preparers, auditors, and users of financial statements and other interested parties.

The proposed SOP would apply to all entities that earn revenue from licensing, selling, or otherwise marketing computer software. However, it would not apply to revenue earned on products or services containing software that is incidental to product or services as a whole.

Respondents should refer to specific paragraph numbers and include reasons for any suggestions or comments.

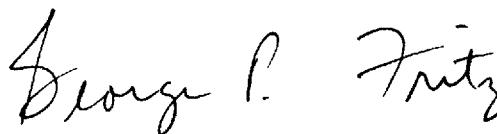
Responses should be addressed to Richard Stuart, Technical Manager, Accounting Standards, File 2354, American Institute of Certified Public Accountants, 1211 Avenue of the Americas, New York, NY 10036-8775 in time to be received by October 14, 1996. Responses also may be sent by electronic mail over the Internet to RSTUART @ AICPA.ORG.

Written comments on the exposure draft will become part of the public record of the AICPA and will be available for public inspection at the AICPA library after November 14, 1996 for one year.

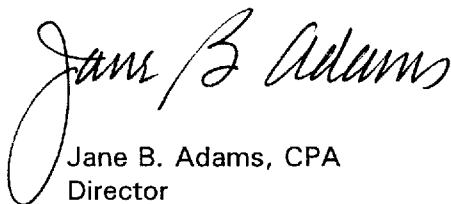
Sincerely,



G. Michael Crooch, CPA  
Chair  
Accounting Standards  
Executive Committee



George P. Fritz, CPA  
Chair  
Software Revenue  
Recognition Working Group



Jane B. Adams, CPA  
Director  
Accounting Standards

**Accounting Standards Executive Committee  
(1995-1996)**

G. Michael Crooch, Chair  
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Louis W. Matusiak, Jr.  
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Charles L. McDonald  
Roger H. Molvar  
Anthony Tricarichi, Jr.

**Software Revenue Recognition Working Group**

George P. Fritz, Chair  
Michele Axelson

H. John Dirks  
Jerry Masters

**AICPA Staff**

Daniel M. Guy  
Vice President  
Professional Standards and  
Services

Jane B. Adams  
Director  
Accounting Standards

Richard Stuart  
Technical Manager  
Accounting Standards

The Accounting Standards Executive Committee and the Software Revenue Recognition Working Group gratefully acknowledge the contributions of the former software revenue recognition task force members Joseph Lhotka, Naomi Erickson, James Gillespie, Francis O'Brien, and Paul Wilde in the development of this proposed Statement of Position.

## SUMMARY

This proposed Statement of Position (SOP) provides guidance on applying generally accepted accounting principles in recognizing revenue on software transactions. This proposed SOP would supersede SOP 91-1, *Software Revenue Recognition*. This proposed SOP requires the following:

- If an arrangement to deliver software or a software system, either alone or together with other products or services, requires significant production, modification, or customization of software, the entire arrangement should be accounted for in conformity with Accounting Research Bulletin No. 45, *Long-Term Construction-Type Contracts*, using the relevant guidance in SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*, unless specified criteria for separate accounting for any service element are met.
- Separate accounting for a service element of an arrangement to which contract accounting applies is required if both of the following criteria are met.
  - The services are not essential to the functionality of any other element of the transaction.
  - The services are stated separately in the contract such that the total price of the arrangement would be expected to vary as the result of inclusion or exclusion of the services.
- If an arrangement to deliver software or a software system does not require significant production, modification, or customization of software, revenue should be recognized when all of the following criteria are met:
  - Persuasive evidence of an agreement exists.
  - Delivery has occurred.
  - The vendor's fee is fixed or determinable.
  - Collectibility is probable.
- Software arrangements may consist of multiple elements, that is, additional software products, upgrades/enhancements, rights to exchange or return software, postcontract customer support (PCS), or services, including elements deliverable only on a when-and-if-available basis. If contract accounting does not apply, the vendor's fee must be allocated to the various elements based on vendor-specific objective evidence of fair values. If sufficient vendor-specific objective evidence of fair values does not exist, all revenue from the arrangement should be deferred until such sufficient evidence exists, or until all elements have been delivered. Exceptions to this guidance are provided for PCS, subscriptions, and arrangements in which the fee is based on the number of copies. Vendor-specific objective evidence is limited to (a) the price charged when the element is sold separately, or (b) if not yet being sold separately, the price for each element established by management having the relevant authority.
- The portion of the license fee allocated to an element should be recognized as revenue when all of the revenue recognition criteria have been met. In applying those criteria, delivery of an element is considered not to have occurred if there are undelivered elements that are essential to the functionality of any delivered elements. Additionally, collectibility of that portion of the fee is not considered to be probable if the amount of the fees

attributable to delivered elements is subject to forfeiture, refund, or other concession if the undelivered elements are not delivered.

The provisions of this proposed SOP are effective for fiscal years beginning after December 15, 1996. Earlier application is encouraged. The cumulative effect of changes caused by adopting the provisions of this proposed SOP should be included in the determination of net income in conformity with Accounting Principles Board Opinion No. 20, *Accounting Changes*.

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## PROPOSED STATEMENT OF POSITION SOFTWARE REVENUE RECOGNITION

### INTRODUCTION

1. Statement of Position (SOP) 91-1, *Software Revenue Recognition*, was issued in 1991 to provide guidance on applying generally accepted accounting principles to software transactions and to narrow the revenue recognition practices in use before its issuance. Since the issuance of SOP 91-1, practice issues have been identified that the AICPA's Accounting Standards Executive Committee (AcSEC) believes are not addressed adequately in SOP 91-1. In addition, AcSEC believes some of the guidance in SOP 91-1 should be reconsidered. This proposed SOP supersedes SOP 91-1.

### SCOPE

2. This proposed SOP provides guidance on when revenue should be recognized and in what amounts for **licensing**<sup>1</sup>, selling, leasing, or otherwise marketing computer software. It applies to all entities that earn revenue from those activities. It does not apply, however, to revenue earned on products or services containing software that is incidental to the products or services as a whole.

### RELATIONSHIP TO OTHER PRONOUNCEMENTS

3. If a lease of software includes property, plant, or equipment, the revenue attributable to the property, plant, or equipment should be accounted for in accordance with Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 13, *Accounting for Leases*, and any revenue attributable to the software, including **postcontract customer support** (PCS), should be accounted for separately in conformity with the guidance set forth in this proposed SOP. However, in conformity with the preceding paragraph, if the property, plant, or equipment contains software that is incidental to the property, plant, or equipment as a whole, the software should not be accounted for separately.

4. A number of the requirements of this proposed SOP are similar to or overlap those in certain pronouncements of the Accounting Principles Board (APB) or the FASB, such as FASB Statement No. 48, *Revenue Recognition When Right of Return Exists*. This proposed SOP does not alter the requirements of any APB Opinion or FASB pronouncement.

### CONCLUSIONS

5. The following conclusions should be read in conjunction with the "Basis for Conclusions" section, beginning with paragraph 94 of this proposed SOP, and the examples in Appendix A.

#### *Basic Principles*

6. Software arrangements range from those that provide a license for a single software product to those that, in addition to the **delivery** of software or a software system, require significant production, modification, or customization of software. If an arrangement to deliver software or a software system, either alone or together with other products or services, requires significant production, modification, or customization of software, the entire arrangement should be

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<sup>1</sup> Terms defined in the glossary are set in **boldface** type the first time they appear in this proposed SOP.

accounted for in conformity with Accounting Research Bulletin (ARB) No. 45, *Long-Term Construction-Type Contracts*, using the relevant guidance herein, and in SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*.<sup>2</sup>

7. If the arrangement does not require significant production, modification, or customization of software, revenue should be recognized when all of the following criteria are met.

- Persuasive evidence of an arrangement exists.
- Delivery has occurred.
- The vendor's fee is fixed or determinable.
- Collectibility is probable.

8. Software arrangements may provide licenses for multiple software products or for multiple software products and services (multiple *elements*). A number of the elements may be described in the arrangement as being deliverable only on a **when-and-if-available** basis. When-and-if-available deliverables should be considered in determining whether or not an arrangement includes multiple elements. Accordingly, the requirements of this proposed SOP with respect to arrangements that consist of multiple elements should be applied to all additional products and services specified in the arrangement, including those described as being deliverable only when-and-if-available.

9. If an arrangement involves multiple elements, the license fee should be allocated to the various elements based on vendor-specific objective evidence of fair value, regardless of any separate prices stated within the contract for each element. Vendor-specific objective evidence of fair value is limited to the following:

- The price charged when the same element is sold separately<sup>3</sup>
- If not yet being sold separately, the price for each element established by management having the relevant authority; it must be probable that the price, once established, will not change before introduction of the element into the marketplace<sup>4</sup>

The amount allocated to the undelivered elements is not subject to later adjustment.<sup>5</sup> However, if it becomes probable that the amount allocated to an undelivered element will result in a loss on that element of the arrangement, the loss should be recognized pursuant to FASB Statement No. 5.

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<sup>2</sup> If a software arrangement includes services that meet the criteria discussed in paragraph 66 of this proposed SOP, those services should be accounted for separately.

<sup>3</sup> If the separate element is an upgrade right, the price charged refers to the price that would be charged to existing users of the software product being upgraded.

<sup>4</sup> The term *probable* is used here with the same definition as used in FASB Statement No. 5, *Accounting for Contingencies*.

<sup>5</sup> This does not apply to changes in the estimated percentage of customers not expected to exercise an upgrade right. See paragraph 36.

10. If sufficient vendor-specific objective evidence does not exist for the allocation of revenue to the various elements of the arrangement, all revenue from the arrangement should be deferred until sufficient vendor-specific objective evidence exists, or until all elements of the arrangement have been delivered. Exceptions to this guidance are provided for PCS, subscriptions, and arrangements for which the fee is based on the number of copies:

- If the only undelivered element is PCS, and sufficient vendor-specific objective evidence does not exist to allocate the arrangement fee, the entire fee should be recognized ratably in conformity with the provisions of paragraphs 57 through 63 of this proposed SOP.
- If the arrangement is accounted for as a subscription, the entire fee should be recognized ratably, in conformity with paragraph 48 of this proposed SOP.
- If the fee is based on the number of copies, the arrangement should be accounted for in conformity with paragraphs 43 through 46 of this proposed SOP.

11. The portion of the fee allocated to an element should be recognized as revenue when the criteria in paragraph 7 of this proposed SOP are met with respect to the element. In applying those criteria, the delivery of an element is considered not to have occurred if there are undelivered elements that are essential to the functionality of the delivered element, because the customer would not have the full use of the delivered element.

12. No portion of the arrangement fee (including amounts otherwise allocated to delivered elements) meets the criterion of collectibility if the portion of the fee attributable to delivered elements is subject to forfeiture, refund, or other concession if the undelivered elements are not delivered. In order for the revenue related to an arrangement to be considered not subject to forfeiture, refund, or other concession, management must intend not to provide refunds or concessions that are not required under the provisions of the arrangement. All available evidence should be considered to determine whether the evidence persuasively indicates that the revenue is not subject to forfeiture, refund, or other concession. Although no single item of evidence may necessarily be persuasive, the following additional items should be considered:

- Acknowledgment in the arrangement of products not currently available or not to be delivered currently
- Separate prices stipulated in the arrangement for each deliverable element
- Default and damage provisions as defined in the arrangement
- Enforceable payment obligations and due dates for the delivered elements that are not dependent on delivery of the future deliverable elements, coupled with the intent of the vendor to enforce rights of payment
- Installation and use of the delivered software
- Support services, such as telephone support, related to the delivered software being provided currently by the vendor

Regardless of the preceding, the vendor's historical pattern of making refunds or other concessions that were not required under the original provisions (contractual or other) of other arrangements should be considered more persuasive than terms included in the arrangement that indicate that no concessions are required.

### ***Evidence of an Arrangement***

13. Practice varies with respect to the use of written contracts. Although a number of sectors of the industry rely upon signed contracts to document arrangements, other sectors of the industry that license software (notably the “packaged” software sector) do not.

14. If the software vendor operates in a manner that does not rely on signed contracts to document the elements and obligations of an arrangement, the vendor should have other forms of evidence to document the transaction (for example, a purchase order or on-line authorization). If the vendor has a customary business practice of utilizing written contracts, evidence of the arrangement is provided only by a contract signed by both parties.

15. Even if all other requirements set forth in this proposed SOP for recognition of revenue are met (including delivery), revenue should not be recognized on any element of the arrangement unless persuasive evidence of an arrangement exists.

### ***Delivery***

16. The second prerequisite in paragraph 7 for revenue recognition is delivery. The principle of not recognizing revenue before delivery applies whether the customer is a **user** or a **reseller**. Except for arrangements in which the license fee is a function of the number of copies delivered to the customer, delivery is considered to have occurred upon transfer of the product master, or if the product master is not to be delivered, upon transfer of the first copy.

17. Paragraphs 18 to 23 of this proposed SOP provide guidance on determining when delivery is considered to have occurred in certain kinds of software transactions.

18. **Customer Acceptance.** After delivery, if uncertainty exists about customer acceptance of the software, license revenue should not be recognized until acceptance occurs.

19. **Determining Delivery — Multiple Copies of Software Products Versus Multiple Licenses.** Arrangements to use multiple copies of a software product under **site licenses** with users and to market multiple copies of a software product under similar arrangements with resellers should be distinguished from arrangements to use or market multiple single licenses of the same software.

- In the former type of arrangement, the vendor may be obligated to furnish up to a specified number of copies of the software, but only if the copies are requested by the user. The licensing fee is payable even if no additional copies are requested by the user or reseller. In such an arrangement, delivery is considered to have occurred when the product master is delivered, and the customer’s right to receive additional copies does not preclude revenue recognition on delivery. In those instances, duplication is incidental to the arrangement and revenue should be recognized on delivery of the first copy or product master if the other criteria in this proposed SOP for revenue recognition are met. Estimated costs of duplication should be accrued at that time.
- In the latter type of arrangement, the licensing fee is a function of the number of copies delivered to the user or reseller, and revenue should be recognized as the copies are made by the user or sold by the reseller if the other criteria in this proposed SOP for revenue recognition are met.

20. *Delivery Other Than to the Customer.* Delivery should not be considered complete unless the destination to which the software is shipped is the customer's place of business or another site specified by the customer. In addition, if a customer specifies an intermediate site but a substantial portion of the fee is not payable until the delivery by the vendor to another site specified by the customer, revenue should not be recognized until the delivery is made to that site.

21. *Delivery Agents.* Vendors may engage agents, often referred to as fulfillment houses, to duplicate and deliver, or only deliver, software products to customers. Revenue from transactions involving delivery agents should be recognized when the software is delivered to the customer. Transferring the fulfillment obligation to an agent of the vendor does not relieve the vendor of the responsibility for delivery. This is the case even if the vendor has no direct involvement in the actual delivery of the software product to the customer.

22. *Authorization Codes.* In a number of software arrangements, vendors use **authorization codes**, commonly referred to as *keys*, to permit customer access to software that otherwise would be restricted. Keys are used in a variety of ways and may serve different purposes. For example, permanent keys may be used to control access to the software, or additional permanent keys may be necessary for duplication of the software. Temporary keys may be used for the same purposes and also may be used to enhance the vendor's ability to collect payment or to control the use of software for demonstration purposes.

23. In software arrangements involving the use of keys, delivery of a key is not necessarily required to satisfy the vendor's delivery responsibility. The software vendor should recognize revenue on delivery of the software if all other requirements for revenue recognition under this proposed SOP and all of the following conditions are met.

- The customer has licensed the software and the vendor has delivered a version of the software that is temporarily fully functional except for the permanent key or the additional keys (if additional keys are used to control reproduction of the software).
- The customer's obligation to pay for the software and the terms of payment, including the timing of payment, are not contingent on delivery of the permanent key or additional keys (if additional keys are used to control reproduction of the software).
- The vendor intends to enforce and has a history of enforcing its right to collect payment under the terms of the original arrangement.

In addition, if a temporary key is used to enhance the vendor's ability to collect payment, delivery of additional keys, whether temporary or permanent, is not required to satisfy the vendor's delivery responsibility if (a) the above conditions are met and (b) the use of a temporary key in such circumstances is a customary practice of the vendor. Selective issuance of temporary keys indicates that collectibility issues exist or that the software is being used for demonstration purposes.

#### ***Fixed or Determinable Fees and Collectibility***

24. The other prerequisites in paragraph 7 for revenue recognition are (1) the vendor's fee is fixed or determinable and (2) collectibility is probable. A software licensing fee would not be fixed or determinable if the amount is based on the number of units distributed or copied, or the expected number of users of the product. Revenue recognition for such variable-pricing arrangements is discussed in paragraphs 42 to 46 of this proposed SOP. Additionally, if an arrangement includes

rights of return, FASB Statement No. 48 states that conditions that must be met in order for the vendor to recognize revenue include (a) the vendor's selling price must be substantially fixed or determinable and (b) the amount of future returns can be reasonably estimated.

25. *Factors That Affect the Determination of Whether a Fee is Fixed or Determinable and Collectible.* A number of arrangements that call for fixed or determinable payments, including minimum royalties or license fees from resellers, specify a payment period that is short in relation to the period during which the customer is expected to use or market the related products. Other arrangements have payment terms that extend over a substantial portion of the period during which the customer is expected to use or market the related products. Since a product's continuing value may be reduced because of the subsequent introduction of enhanced products by the vendor or its competitors, the possibility that the vendor may provide a refund or concession to the customer to liquidate outstanding amounts due under terms of the initial transaction increases as payment terms become longer.

26. A software licensing fee should be presumed not to be fixed or determinable if payment of a significant portion of the licensing fee is not due until after expiration of the license or more than twelve months after delivery. However, in some such situations, vendors may consider a fee fixed or determinable. For example, a vendor may have a business practice of using installment contracts and an extended history of entering into contracts with terms in excess of twelve months and successfully enforcing payment terms without making additional concessions. Such a vendor may consider such fees fixed or determinable and may recognize revenue upon delivery of the software, provided all other conditions for revenue recognition in this proposed SOP have been satisfied.

27. If a presumption that a fee is fixed or determinable cannot be made at the outset of an arrangement, revenue should be recognized as payments from customers become due (assuming the criteria in paragraph 11 have been satisfied).

28. For reseller arrangements, the following factors also should be considered in evaluating whether the fixed or determinable fee and collectibility criteria for revenue recognition are met.

- Business practices, the reseller's operating history, competitive pressures, informal communications, or other factors indicate that payment is substantially contingent on the reseller's success in distributing individual units of the product<sup>6</sup>
- Resellers are new, undercapitalized, or in financial difficulty and may not demonstrate an ability to honor a commitment to make fixed or determinable payments until they collect cash from their customers
- Uncertainties about the potential number of copies to be sold by the reseller may indicate that the amount of future returns cannot be reasonably estimated on delivery; examples of such factors include the newness of the product or marketing channel, competitive products, or dependence on the market potential of another product offered (or anticipated to be offered) by the reseller

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<sup>6</sup> Contractual arrangements under which the reseller is obligated to pay only as and if sales are made to users should be accounted for as consignments.

- Distribution arrangements with resellers require the vendor to rebate or credit a portion of the original fee if the vendor subsequently reduces its price for a product and the reseller still has that software product in its inventory (sometimes referred to as price protection). Significant uncertainties about the vendor's ability to maintain its price or reasonably estimate future price changes in light of competitive conditions or its own future product introduction plans indicate the vendor's selling price is not fixed or determinable at the date of delivery

29. *Cancelable Licenses.* Fees from licenses cancelable by customers are neither fixed nor determinable until the cancellation privileges lapse. Fees from licenses with cancellation privileges expiring ratably over the license period are considered to become determinable ratably over the license period as the cancellation privileges lapse. In applying the provisions of this paragraph, obligations related to warranties, including warranties that are routine, short-term, and relatively minor, should be accounted for in conformity with FASB Statement No. 5. Additionally, short-term rights of return, such as thirty-day money-back guarantees, should not be considered cancellation privileges; the related returns should be accounted for in conformity with FASB Statement No. 48.

30. *Fiscal Funding Clauses.* Fiscal funding clauses commonly are found in software license arrangements in which the licensees are governmental units. Such clauses generally provide that the license is cancelable if the legislature or funding authority does not appropriate the funds necessary for the governmental unit to fulfill its obligations under the licensing arrangement.

31. Consistent with FASB Technical Bulletin No. 79-10, *Fiscal Funding Clauses in Lease Agreements*, a software licensing arrangement with a governmental unit containing a fiscal funding clause should be evaluated to determine whether the uncertainty of a possible license arrangement cancellation is a remote contingency. The evaluation of whether the level of uncertainty of possible cancellation is remote should be consistent with FASB Statement No. 5, which defines *remote* as relating to conditions in which "the chance of the future event or events occurring is slight."

32. The existence of a fiscal funding clause in a software licensing arrangement with a governmental unit necessitates an assessment of the likelihood of license cancellation through exercise of the fiscal funding clause. If the likelihood is assessed as remote, the software licensing arrangement should be considered noncancelable. Such an assessment should include the factors discussed in paragraph 25 of this proposed SOP. If the likelihood is assessed as other than remote, the license should be considered cancelable, thus precluding revenue recognition. A fiscal funding clause with a customer other than a governmental unit creates a contingency that precludes revenue recognition until the requirements of the clause and all other provisions of this proposed SOP have been satisfied.

#### ***Multiple-Element Arrangements***

33. As discussed in paragraph 9 of this proposed SOP, multiple-element software arrangements to which contract accounting does not apply may include customer rights to any combination of additional software deliverables, services, or PCS. If contract accounting does not apply, elements in such arrangements should be accounted for in accordance with paragraphs 7 to 12 of this proposed SOP. Guidance on the application of those paragraphs to multiple-element software arrangements is given in paragraphs 34 to 74 of this proposed SOP.

### *Additional Software Deliverables and Rights to Exchange or Return Software*

34. As part of a multiple-element software arrangement, a software vendor may agree to deliver software currently and to deliver additional software in the future. The additional deliverables may include **upgrades/enhancements** or additional software products. Additionally, a vendor may provide the customer with the right to exchange or return software, including the right to transfer software from one hardware **platform** or operating system to one or more other platforms or operating systems (a **platform-transfer right**).

35. **Upgrades/enhancements.** As part of a multiple-element software arrangement, a software vendor may agree to deliver software currently and provide the customer with an **upgrade right** for a specified upgrade/enhancement. The upgrade right may be evidenced by a specific agreement, commitment, or the vendor's established practice.<sup>7</sup> (Rights to receive *unspecified* upgrades/enhancements on a when-and-if-available basis are PCS, as it has been redefined in this proposed SOP.) The upgrade right should be accounted for in accordance with paragraphs 7 through 12 of this proposed SOP. Guidance on the application of those paragraphs to multiple-element software arrangements that include upgrade rights is given in paragraphs 36 and 37.

36. If a multiple-element software arrangement includes an upgrade right, the license fee should be allocated between the elements based on vendor-specific objective evidence of fair value. The fee allocated to the upgrade right (see paragraph 9) is the price for the **upgrade/enhancement** that would be charged to existing users of the software product being updated. If sufficient vendor-specific evidence exists to reasonably estimate the percentage of customers that are not expected to exercise the upgrade right, the fee allocated to the upgrade right should be reduced to reflect that percentage. This estimated percentage should be reviewed periodically. The effect of any change in that percentage should be accounted for as a change in accounting estimate.

37. The amount of the license fee allocated to the upgrade right should be recognized as revenue when the conditions in paragraphs 7 through 12 of this proposed SOP are met. If sufficient vendor-specific objective evidence does not exist for the allocation of the license fee to the upgrade right, revenue from the arrangement should be deferred until such sufficient vendor-specific objective evidence exists, or until all elements of the arrangement have been delivered.

38. **Additional Software Products.** As part of a multiple-element software arrangement, a software vendor may agree to deliver software currently and deliver specified additional software products in the future. The rights to these additional products may be either stand-alone or included in the terms of a PCS arrangement. Whether or not the rights to the additional software products are included in a PCS arrangement, the revenue attributable to the additional software products should be accounted for separately from the PCS arrangement.

39. Multiple-element software arrangements that include rights to undelivered additional software products that are not subscriptions (see paragraphs 47 and 48) should be accounted for in accordance with paragraphs 7 through 12 of this proposed SOP. Guidance on the application of those paragraphs to such arrangements is provided in paragraphs 40 through 48 below.

40. The fee from the arrangement should be allocated among the products based on vendor-specific objective evidence of fair value. The allocation should be based on the relative sales prices (determined pursuant to paragraph 9 of this proposed SOP) of the products. If the vendor does

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<sup>7</sup> Also, a vendor may offer an upgrade right related to a specific upgrade/enhancement to be delivered in the future that the user would otherwise be entitled to on an unspecified basis.



not have vendor-specific objective evidence, paragraph 10 of this proposed SOP requires that all revenue from the arrangement be deferred until the evidence exists, or until all elements have been delivered. If a discount is offered on the multiple-product arrangement, the proportionate amount of that discount should be applied to each product included in the arrangement based on each product's fair value without regard to the discount. The fee allocated to the additional software products should not be reduced by the percentage of any customers that might not be expected to exercise the right to receive additional software products.

41. If the software arrangement is based on a price per product (not a price per copy), the portion of the fee allocated to a product should be recognized as revenue when the product is delivered, assuming all other provisions of paragraphs 7 through 12 of this proposed SOP are met.

42. Some **fixed fee** license or reseller arrangements provide customers with the right to reproduce or obtain copies at a specified price per copy (rather than per product) of two or more software products up to the total amount of the fixed fee. A number of the products covered by the arrangement may not be deliverable or specified at the inception of the arrangement. Although the price per copy is fixed at the inception of the arrangement, an allocation of the arrangement fee to the individual products generally cannot be made, because the total revenue attributable to each software product is unknown and depends on choices to be made by the customer and, sometimes, future development activity while the arrangement is in effect. However, as discussed in paragraph 45 of this proposed SOP, in certain situations, revenue can be allocated to the products that are undeliverable or not specified at the inception of the arrangement.

43. In arrangements in which no allocation can be made, until the first copy or product master of each product covered by the arrangement has been delivered to the customer, assuming the provisions of paragraphs 7 to 12 of this proposed SOP are met, revenue should be recognized (a) as copies of delivered products are reproduced by the customer or (b) as copies of delivered products are furnished to the customer if the vendor is duplicating the software. Once the vendor has delivered the product master or first copy of all products covered by the arrangement, any licensing fees not previously recognized should be recognized. (At this point, only duplication of the software is required to satisfy the vendor's delivery requirement. As discussed in paragraphs 19 and 105 of this proposed SOP, duplication of the software is incidental to the arrangement, and delivery is deemed to have occurred upon delivery of the product master or first copy.) When the arrangement terminates, the vendor should recognize any licensing fees not previously recognized.

44. The revenue from such arrangements should not be fully recognized until at least one of the following conditions is met:

- Delivery is complete for all products covered by the arrangement.
- The aggregate revenue attributable to all copies of the software products delivered is equal to the fixed fee, provided that the vendor is not obligated to deliver additional software products under the arrangement.

45. However, certain software arrangements that include products that are not deliverable or specified at the inception specify a maximum number of copies of the undeliverable product(s) to which the customer is entitled. In such arrangements, a portion of the arrangement fee should be allocated to the undeliverable product(s). This allocation should be made assuming the customer will elect to receive the maximum number of copies of the undeliverable product(s).

46. The revenue allocated to the delivered products should be recognized when the product master or first copy is delivered. If, during the term of the arrangement, the customer reproduces

or receives enough copies of these delivered products so that revenue attributable to the delivered products exceeds the revenue previously recognized, such additional revenue should be recognized as the copies are reproduced or delivered. The revenue allocated to the undeliverable product(s) should be reduced by a corresponding amount.

47. As part of a multiple-element software arrangement, a vendor may agree to deliver software currently and to deliver *unspecified* additional software products in the future (including unspecified platform transfer rights that do not qualify for like-kind exchange accounting as described in paragraphs 51 to 56 of this proposed SOP). For example, the vendor may agree to deliver all new products to be introduced in a family of products over the next two years. These arrangements are similar to arrangements that include PCS in that future deliverables are unspecified. They are distinguished from arrangements that include PCS, however, because the future deliverables are products, not unspecified upgrades/enhancements. These arrangements do not meet the criteria in paragraph 9 of this proposed SOP, since vendor-specific objective evidence does not exist upon which to base the allocation of the arrangement fee to the products.

48. The software elements of such arrangements should be accounted for as subscriptions. Accordingly, no allocation of revenue should be made among any of the software products, and all software product-related revenue from the arrangement should be recognized ratably over the term of the arrangement beginning with delivery of the first product. However, if the term of the arrangement is not stated, the revenue should be recognized ratably over the estimated economic life of the products covered by the arrangement, beginning with delivery of the first product.

49. If the terms of the arrangement obligate the vendor to deliver future unspecified upgrades/enhancements, the arrangement should be accounted for as a subscription. An intent on the part of the vendor not to develop new products during the term of the arrangement does not relieve the vendor of the requirement to recognize revenue ratably over the term of the arrangement, beginning with the delivery of the first product, as discussed in the previous paragraph.

50. *Rights to Exchange or Return Software.* As part of a software arrangement, a software vendor may provide the customer with the right to return software or to exchange software for products with no more than minimal differences in price, functionality, and features. The accounting for returns is significantly different from the accounting for exchanges. Although it is sometimes difficult to determine whether a transaction is a return or exchange of software, the fact that the software is not returned physically does not preclude return accounting.

51. *Users.* As part of a multiple-element software arrangement, a software vendor may agree to deliver software currently and provide the customer with the right to exchange that software for products with no more than minimal differences in price, functionality, and features. Such exchanges of software, if the right to make the exchange is offered to users (but not resellers), are analogous to exchanges "by ultimate customers of one item for another of the same kind, quality, and price . . . [that] are not considered returns" described in footnote 3 of FASB Statement No. 48. Conversely, exchanges by users of software products for different software products or for similar software products with more than minimal differences in price, functionality, or features are considered returns, and revenue related to agreements that provide users with rights to make such exchanges should be accounted for in conformity with FASB Statement No. 48. If the other product(s) is not available at the time the initial product is delivered, there should be persuasive evidence that demonstrates that there will be no more than minimal differences in price, features, and functionality among the products in order for the transaction to qualify as an exchange. Additionally, if the vendor expects to incur a significant amount of development costs related to

the other product, the other product should be considered to have more than a minimal difference in functionality.

52. As part of a multiple-element software arrangement, a vendor may grant a user a platform-transfer right. Depending on the circumstances, the exercise of a platform-transfer right may represent either an exchange or a return for accounting purposes. If the customer legally is entitled to continue to use the software that was originally delivered (in addition to the software that is to be delivered for the new platform), the platform transfer right should be accounted for in the manner prescribed in the section "*Additional Software Products*" (paragraphs 38 to 47).

53. If as part of a multiple-element software arrangement, a software vendor offers a user (not a reseller) a platform-transfer right, and the provisions of paragraphs 7 to 12 of this proposed SOP are met, the revenue from the software license should be recognized upon the initial delivery of the software, and the exercise of the platform-transfer right should be treated as a like-kind exchange, if the platform-transfer right —

- Is for the same product (see paragraph 54)
- Does not increase the number of copies or concurrent users of the software product available under the license arrangement

54. Products are considered to be the same product if there are no more than minimal differences among them in prices, features, and functions and they are marketed as the same product, although there may be differences arising from environmental variables such as operating systems, databases, user interfaces, and platform scales. Indicators of "marketed as the same product" include (a) the same product name (although version numbers may differ) and (b) a focus on the same features and functions.

55. Additional fees charged at the time of transfer, such as platform-scale surcharges or handling fees, should be recognized as revenue when earned.

56. Resellers. As part of their standard sales terms or as a matter of practice, vendors may grant resellers rights to exchange unsold software for other software (including software that runs on a different hardware platform or operating system). Because the reseller is not the ultimate customer (see paragraph 51), such exchanges, including those referred to as stock balancing arrangements, should be accounted for as returns. Arrangements that grant rights to make such exchanges should be accounted for in conformity with FASB Statement No. 48, even if the vendors require the resellers to purchase additional software to exercise the exchange rights.

#### *Postcontract Customer Support*

57. Software arrangements may include the right to PCS. PCS includes the right to receive PCS services or *unspecified* upgrades/enhancements<sup>8</sup>, or both, offered to users or resellers. A vendor may develop historical patterns of regularly providing all customers or certain kinds of customers with services or unspecified upgrades/enhancements normally associated with PCS, or may anticipate doing so, even though there is no written contractual obligation or the stipulated PCS term commences at some date after delivery. In those situations, an implied PCS arrangement exists that commences upon product delivery. For purposes of applying the guidance in this

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<sup>8</sup> This proposed SOP defines PCS to exclude rights to *specific* upgrades/enhancements.

proposed SOP, PCS includes a vendor's expected performance based on such patterns, even if performance is entirely at the vendor's discretion and not pursuant to a formal agreement.

58. If a multiple-element software arrangement includes explicit or implicit rights to PCS, and the revenue-allocation conditions in paragraph 9 of this proposed SOP are satisfied, the total fees from the arrangement should be allocated between the elements based on vendor-specific objective evidence of fair value. The portion of the fee allocated to PCS should be recognized as revenue ratably over the term of the PCS arrangement, because the PCS services are assumed to be provided ratably. However, if there is sufficient vendor-specific historical evidence that costs to provide PCS (including allocated portions of costs accounted for as research and development costs and amortization of costs related to the upgrade/enhancement capitalized in conformity with FASB Statement No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*) are incurred on other than a straight-line basis and the vendor believes that it is probable that the costs incurred in performing under the current arrangement will follow a similar pattern, revenue should be recognized over the period of the PCS arrangement in proportion to the amounts expected to be charged to expense for the PCS services rendered during the period. Because the timing, frequency, and significance of unspecified upgrades/enhancements can vary considerably, the point at which unspecified upgrades/enhancements are expected to be delivered should not be used to support income recognition on other than a straight-line basis.

59. If sufficient vendor-specific objective evidence does not exist to allocate the license fee to the separate elements, the entire arrangement fee should be recognized ratably over the period during which PCS is expected to be provided.

60. PCS revenue may be recognized together with the initial licensing fee on delivery of the software if all of the following conditions are met:

- a. The PCS fee is included with the initial licensing fee.
- b. The PCS included with the initial license is for one year or less.
- c. The estimated cost of providing PCS during the arrangement is insignificant.
- d. Unspecified upgrades/enhancements offered during PCS arrangements historically have been and are expected to continue to be minimal and infrequent.

If PCS revenue is recognized upon delivery of the software, the vendor must accrue all estimated costs of providing the services, including upgrades/enhancements. Upgrades/enhancements are not developed solely for distribution to PCS customers; revenues are expected to be earned from providing the enhancements to other customers, as well. Therefore, costs should be allocated between PCS arrangements and other licenses.

61. A determination that unspecified upgrades/enhancements offered during the PCS arrangement are expected to be minimal and infrequent should be evidenced by patterns of minimal and infrequent unspecified upgrades/enhancements offered on previous PCS arrangements. A conclusion that unspecified upgrades/enhancements are expected to be minimal and infrequent should not be reached simply because unspecified upgrades/enhancements have been or are expected to be offered less frequently than on an annual basis. Regardless of the vendor's history of offering unspecified upgrades/enhancements to initial licensees, PCS should be accounted for separately from the initial licensing fee if the vendor expects to offer upgrades/enhancements that are greater than minimal or more than infrequent to the users or resellers of the licensed software during the PCS arrangement.

62. Postdelivery Telephone Support at No Additional Charge. Postdelivery telephone support provided to users by the vendor at no additional charge should be accounted for as PCS, in conformity with this proposed SOP, regardless of whether the support is explicitly provided under the licensing arrangement. Although such telephone support may be offered or available for periods exceeding one year, if the vendor has established a history of providing substantially all the telephone support within one year of the licensing or sale of the software, the PCS may be considered to have a term of one year or less in applying paragraph 60(b) of this SOP. Accordingly, revenue attributable to telephone support may be recognized together with the initial licensing fee on delivery of the software if all the conditions in paragraph 60 of this proposed SOP are met. This provision applies only to telephone support provided at no additional charge. If revenue attributable to telephone support is recognized together with the licensing fee on delivery, the vendor should accrue the estimated cost of providing that support.

63. PCS Granted by Resellers. An arrangement in which a vendor grants a reseller the right to provide unspecified upgrades/enhancements to the reseller's customers is an implied PCS arrangement between the vendor and the reseller, even if the vendor does not provide direct telephone support to the reseller's customers. If sufficient vendor-specific objective evidence does not exist to allocate the license fee to the software and the PCS, revenue from both the licensing arrangement and the PCS should be recognized ratably over the period during which PCS is expected to be provided.

#### *Services*

64. Certain software arrangements not initially accounted for using contract accounting include both software and service elements (other than PCS-related services). The services may include training, installation, or consulting. Consulting services often include implementation support, software design or development, or the customization or modification of the licensed software.

65. If a software arrangement includes such services, a determination must be made as to whether or not the service element can be accounted for separately as the services are performed. Paragraphs 66 to 67 of this proposed SOP discuss the criteria that must be considered in making such a determination. If the nature of the services is such that the service element does not qualify as a separate service transaction, contract accounting must be applied to both the software and service elements included in the arrangement. Paragraphs 75 to 92 of this proposed SOP address the application of contract accounting to arrangements that do not qualify for service-transaction accounting.

66. Service Elements. In order to account separately for the service element of a software arrangement that includes both software and services, the revenue allocation provisions of paragraph 9 of this proposed SOP must be met and the services (a) must not be essential to the functionality of any other element of the transaction and (b) must be stated separately such that the total price of the arrangement would be expected to vary as the result of the inclusion or exclusion of the services.

67. If a software arrangement includes services that meet the criteria of paragraph 66, revenue should be allocated between the service and software elements of the contract. This allocation should be based on vendor-specific objective evidence of fair values, regardless of whether separate prices are assigned to the service element of the arrangement.<sup>9</sup>

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<sup>9</sup> A software vendor may offer discounts on licensing fees and services included in the arrangement. Regardless of whether separate prices are assigned to the service element of the arrangement, the prices allocated to the elements should be based on vendor-specific objective evidence, as discussed in paragraph 9

68. If the criteria in paragraph 66 are met, revenue from the service element should be recognized as the services are performed or, if no pattern of performance is discernible, on a straight-line basis over the period during which the services are performed. If the criteria in paragraph 66 are not met, the entire arrangement should be accounted for under contract accounting, in accordance with the provisions of paragraphs 75 to 92 of this proposed SOP.

69. An important factor to consider in determining whether the services are essential to the functionality of any other element is whether the software included in the arrangement is considered **off-the-shelf** or **core software**. Core software is software that a vendor uses in creating other software. It is not sold as is because customers cannot use it unless it is customized to meet system objectives or customer specifications. Off-the-shelf software is software that is marketed as a stock item that can be used by customers with little or no customization.

70. Software should be considered off-the-shelf software if it can be added to an arrangement with no or only minor changes in the underlying code and it could be used by the customer for the customer's purposes upon installation. Actual use by the customer and performance of other elements of the arrangement is not required to demonstrate that the customer could use the software off-the-shelf. If more than minor modifications or additions to the off-the-shelf software are necessary to meet the customer's purpose (for example, changing or making additions to the software, or because it would not be usable in its off-the-shelf form in the customer's environment), the software should be considered core software for purposes of that arrangement. If the software that is included in the arrangement is not considered to be off-the-shelf software, or if more than minor modifications or additions to the off-the-shelf software are necessary to meet the customer's functionality, no element of the arrangement would qualify for accounting as a service, and contract accounting should be applied to both the software and service elements of the arrangement.

71. Factors indicating that the service element is essential to the functionality of the other elements of the arrangement, and consequently should not be accounted for separately, include the following:

- The software is not off-the-shelf software.
- The services include more than minor alterations to the features and functionality of the off-the-shelf software.
- The timing of payments for the software is coincident with performance of the services.
- Milestones or customer-specific acceptance criteria affect the realizability of the software-license fee.

72. Judgment is required in determining whether the obligation to provide services in addition to the delivery of software should be accounted for separately as a service element. Services that qualify for accounting as a service element of a software arrangement are always stated separately and generally have at least several of the following characteristics.

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of this proposed SOP. The best indications of fair values for the service and nonservice elements of a transaction are the prices charged by the vendor when such elements are sold separately. However, revenue recognized on the elements delivered should be no more than the amount that the customer would be required to pay in the event the vendor fails to perform on the other elements of the arrangement.

- The services are available from other vendors.
- The services do not carry a significant degree of risk or unique acceptance criteria.
- The software vendor is an experienced provider of the services.
- The vendor is providing primarily implementation services, such as implementation planning, loading of software, training of customer personnel, data conversion, building simple interfaces, running test data, and assisting in the development and documentation of procedures.
- Customer personnel are dedicated to participate in the services being performed.

73. ***Funded Software-Development Arrangements.*** Software-development arrangements that are fully or partially funded by a party other than the vendor that is developing the software typically provide the funding party with some or all of the following benefits:

- Royalties payable to the funding party based solely on future sales of the product by the software vendor (that is, reverse royalties)
- Discounts on future purchases by the funding party of products produced under the arrangement
- A nonexclusive sublicense to the funding party, at no additional charge, for the use of any product developed (a prepaid or paid-up nonexclusive sublicense)

74. A funded software-development arrangement within the scope of FASB Statement No. 68, *Research and Development Arrangements*, should be accounted for in conformity with that Statement. If technological feasibility of the computer software product pursuant to the provisions of FASB Statement No. 86 has been established before the arrangement has been entered into, FASB Statement No. 68 does not apply because the arrangement is not a research and development arrangement. Accounting for costs related to funded software-development arrangements is beyond the scope of this SOP. However, if capitalization of the software-development costs commences pursuant to FASB Statement No. 86, any income from the funding party under a funded software-development arrangement should be credited first to the amount of development costs capitalized. If the income from the funding party exceeds the amount of development costs capitalized, the excess should be deferred and credited against future amounts that subsequently qualify for capitalization. Any deferred amount remaining after the project is completed should be credited to income.

### ***Contract Accounting***

75. If an arrangement to deliver software or a software system, either alone or together with other products or services, requires significant production, modification, or customization of software, and the service element does not meet the criteria for separate accounting set forth in paragraph 66, the entire arrangement should be accounted for in conformity with ARB No. 45, using the relevant guidance in SOP 81-1.

76. In applying contract accounting, the vendor must use either the percentage-of-completion method or the completed-contract method. The determination of which of these methods should be used should be made according to the recommendations in paragraphs 21 through 33 of SOP 81-1.

77. Segmentation. A number of software contracts have discrete elements that meet the criteria for segmenting in paragraphs 39 to 42 of SOP 81-1. If a contract is segmented, each segment is treated as a separate profit center. Progress-to-completion for each segment should be measured in conformity with paragraphs 79 to 81 of this proposed SOP.

78. A number of vendors of arrangements that include software combined with services or hardware or both do not identify the elements separately and do not sell them separately because of agreements with their suppliers. Other vendors who are not restricted by such agreements nevertheless bid or negotiate software and other products and services together. Arrangements that do not meet the segmentation criteria in paragraph 40 of SOP 81-1 are precluded from being segmented, unless the vendor has a history of providing the software and other products and services to customers under separate arrangements and the arrangement meets the criteria in paragraph 41 of SOP 81-1.

79. Measuring Progress-to-Completion Under the Percentage-of-Completion Method. Paragraph 46 of SOP 81-1 describes the approaches to measuring progress on contracts (or segments thereof) under the percentage-of-completion method. Those approaches are grouped into input and output measures, as follows:

Input measures are made in terms of efforts devoted to a contract. They include . . . methods based on costs and on efforts expended. Output measures are made in terms of results achieved. They include methods based on units produced, units delivered, contract milestones, and value added. For contracts under which separate units of output are produced, progress can be measured on the basis of units of work completed.

For software contracts, an example of an input measure is labor hours; an example of an output measure is arrangement milestones, such as completion of specific program modules.

80. If, as discussed in paragraph 77 of this proposed SOP, a software contract includes a discrete element that meets the segmentation criteria of SOP 81-1, the method chosen to measure progress-to-completion on the element should be the method that best approximates progress-to-completion. Progress-to-completion on separate elements of the same software arrangement may be measured by different methods. However, the software vendor should choose measurement methods consistently, so that it uses similar methods to measure progress-to-completion on similar elements.

81. Output measures, such as value-added or arrangement milestones, may be used to measure progress-to-completion on software arrangements, but many companies use input measures because they are more easily established. As noted in paragraph 47 of SOP 81-1, "The use of either type of measure requires the exercise of judgment and the careful tailoring of the measure to the circumstances." Further, paragraph 51 of SOP 81-1 states that

...the acceptability of the results of input or output measures deemed to be appropriate to the circumstances should be periodically reviewed and confirmed by alternative measures that involve observation and inspection. For example, the results provided by the measure used to determine the extent of progress may be compared to the results of calculations based on physical observations by engineers, architects, or similarly qualified personnel. That type of review provides assurance somewhat similar to that provided for perpetual inventory records by periodic physical inventory counts.



82. Input Measures. Input measures of progress-to-completion on arrangements are made in terms of efforts devoted to the arrangement and, for software arrangements, include methods based on costs, such as cost-to-cost measures, and on efforts expended, such as labor hours or labor dollars. Progress-to-completion is measured indirectly, based on an established or assumed relationship between units of input and productivity. A major advantage of input measures is that inputs expended are easily verifiable. A major disadvantage is that their relationship to progress-to-completion may not hold if inefficiencies exist or if the incurrence of the input at a particular point in time does not indicate progress-to-completion.

83. Costs incurred should be included in measuring progress-to-completion only to the extent that they relate to contract performance. Items not specifically produced for the arrangement, such as hardware purchased from third parties or off-the-shelf software, should not be included in the measurement of progress-to-completion.

84. Labor hours often are chosen as the basis for measuring progress-to-completion, because they closely approximate the output of labor-intensive processes and are often more verifiable than output measures. Core software requires labor-intensive customization. Therefore, labor hours provide a good measure of progress-to-completion on elements of software arrangements that involve customization of core software. However, labor expended in the development of any core software that has been or is planned to be marketed to additional enterprises should not be included in the measurement of progress-to-completion because such core software is not produced specifically for the arrangement.

85. If the measurement of progress-to-completion is based primarily on costs, the contribution to that progress of hardware and software that were produced specifically for the arrangement may be measurable and recognizable before delivery to the user's site. For example, efforts to install, configure, and customize the software, and similar activities, may occur at the vendor's site. The costs of such activities are measurable and recognizable at the time the activities are performed.

86. Output Measures. Progress on arrangements that call for production of identifiable units of output can be measured in terms of value added or milestones reached. Although progress-to-completion based on output measures is measured directly from results achieved, thus providing a better approximation of progress than is provided by input measures, output measures may be somewhat unreliable because of the difficulties associated with establishing them.

87. In order for value added to be verifiable, the vendor must identify elements or subcomponents of those elements. If output measures are not known or reasonably estimable, they should not be used to measure progress-to-completion.

88. If value added by off-the-shelf software is to be included in the measurement of progress-to-completion, such software cannot require more-than-minor modifications and must be usable by the customer for the customer's purpose in the customer's environment. If more-than-minor modifications or additions to the off-the-shelf software are necessary to meet the functionality required under the arrangement terms, either by changing or making additions to the software, or because the software would not be usable by the customer in its off-the-shelf form for the customer's purpose in the customer's environment, it should be accounted for as core software.

89. Value added by the customization of core software should be included in the measurement of progress-to-completion of the customization and installation at the user's site. However, if the installation and customization processes are divided into separate output modules, the value of core software associated with the customization of a module should be included in the measurement of progress-to-completion when that module is completed.

90. Contract milestones may be based on contractual project plans. Contractual provisions generally require the performance of specific tasks with the approval or acceptance by the customer; project plans generally schedule inspections in which the project's status is reviewed and approved by management. The completion of tasks that trigger such inspections are natural milestones because they are subject to relatively independent review as an intrinsic part of the project management process.

91. Considerations other than progress-to-completion affect the amounts that become billable at particular times under many arrangements. Accordingly, although the achievement of contract milestones may cause arrangement revenues to become billable under the arrangement, the amounts billable should be used to measure progress-to-completion only if such amounts indeed indicate such progress.

92. The milestones that are selected to measure progress-to-completion should be part of the management review process. The percentage-of-completion designated for each milestone should be determined considering the experience of the vendor on similar projects.

#### **EFFECTIVE DATE AND TRANSITION**

93. This proposed SOP is effective for fiscal years beginning after December 15, 1996. Earlier application is encouraged. The cumulative effect of changes caused by adopting the provisions of this proposed SOP should be included in the determination of net income in conformity with APB Opinion 20, *Accounting Changes*, paragraph 20. Pro forma effects of retroactive application (APB Opinion 20, paragraph 21) are not required. Previously issued financial statements should not be restated.

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| <p><b>The provisions of this Statement need<br/>not be applied to immaterial items.</b></p> |
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## BASIS FOR CONCLUSIONS

### ***Background***

94. SOP 91-1 was issued in December 1991. AcSEC understands that certain provisions of the SOP are being applied inconsistently in practice and that various practice issues have arisen that were not addressed in SOP 91-1. As a result, AcSEC added a project to its agenda in March 1993 to interpret those provisions and provide additional guidance. The key issues identified at the outset of the project related to accounting for arrangements that provided for multiple deliverables (including PCS). The project began as an amendment to SOP 91-1. However, as deliberations progressed, AcSEC determined that it would be more appropriate to supersede SOP 91-1 to (a) amend the provisions in question and (b) incorporate AcSEC's conclusions on practice issues that had not been addressed in SOP 91-1.

### ***Basic Principles***

95. Transfers of rights to software by licenses rather than by outright sales protect vendors from unauthorized duplication of their products. However, the rights transferred under software licenses are substantially the same as those expected to be transferred in sales of other kinds of products. AcSEC believes the legal distinction between a license and a sale should not cause revenue recognition on software products to differ from revenue recognition on the sale of other kinds of products.

96. Arrangements to deliver software or a software system, either alone or together with other products, may include services. AcSEC believes that if those services entail significant production, modification, or customization of the software, such software before those alterations (even if already delivered) is not the product that has been purchased by the customer. Instead, the product purchased by the customer is the software that will result from the alterations. Accordingly, AcSEC concluded that arrangements that include services that entail significant production, modification, or customization of software qualify as construction-type or production-type contracts, and should be accounted for in conformity with ARB 45 and SOP 81-1. AcSEC concluded that if the services do not entail significant production, modification, or customization of software, the service element should be accounted for as a separate element.

97. AcSEC believes that revenue generally should not be recognized until the element has been delivered. The recognition of revenue from product sales on delivery is consistent with paragraphs 83(b) and 84 of FASB Concepts Statement No. 5, *Recognition and Measurement in Financial Statements of Business Enterprises*. Paragraph 83(b) provides the following guidance for recognition of revenues:

Revenues are not recognized until earned. An entity's revenue-earning activities involve *delivering* or producing goods, rendering services, or other activities that constitute its ongoing major or central operations, and revenues are considered to have been earned when the entity has substantially accomplished what it must do to be entitled to the benefits represented by the revenues. [Footnote omitted.][Emphasis added.]

Paragraph 84 states that in recognizing revenues and gains:

...[t]he two conditions [for revenue recognition] (being realized or realizable and being earned) are usually met by the time the product or merchandise is

delivered...to customers, and revenues...are commonly recognized at time of sale (usually meaning *delivery*). [Emphasis added.]

98. SOP 91-1 did not address arrangements that included software that was deliverable only when-and-if-available. Implementation questions arose as to whether when-and-if-available terms created contingencies that could be disregarded in determining whether an arrangement consists of multiple elements. AcSEC believes that because the when-and-if-available deliverables were bargained for in the arrangement, they are of value to the customer. Accordingly, AcSEC concluded that when-and-if-available deliverables should be considered in determining whether an arrangement consists of multiple elements. Thus, the requirements of this proposed SOP with respect to arrangements that consist of multiple elements should be applied to all additional products and services specified in the arrangement, including those described as being deliverable only when-and-if-available.

99. In SOP 91-1, the accounting for vendor obligations remaining after delivery of the software was dependent upon whether the obligation was significant or insignificant. However, these determinations were not being made in a consistent manner, leading to a diversity in practice. AcSEC believes that all obligations should be accounted for and that revenue from the arrangement should be allocated to each element of the arrangement, based on vendor-specific objective evidence of fair values of the elements. Further, AcSEC concluded that revenue related to a particular element should not be recognized until the revenue-recognition conditions in paragraphs 7 to 12 of this proposed SOP are met, because the earnings process related to that particular element is not considered complete until that time.

100. In paragraph 9 of this proposed SOP, AcSEC concluded that the revenue from an arrangement should be allocated to the separate elements based on vendor-specific objective evidence of fair value, regardless of any separate prices stated in the contract for each element. AcSEC believes that separate prices stated in a contract may not represent fair value and, accordingly, might result in an unreasonable allocation of revenue. AcSEC believes that basing the allocation on fair values is consistent with the accounting for commingled revenue. For example, as discussed in paragraph 12 of FASB Statement No. 45, *Accounting for Franchise Fee Revenue*:

The franchise agreement ordinarily establishes a single initial franchise fee as consideration for the franchise rights and the initial services to be performed by the franchisor. Sometimes, however, the fee also may cover tangible property, such as signs, equipment, inventory, and land and building. In those circumstances, the portion of the fee applicable to the tangible assets shall be based on the fair value of the assets.

101. AcSEC considered allowing the use of surrogate prices such as competitor prices for similar products or industry averages to determine fair value. However, AcSEC believes that inherent differences exist between elements offered by different vendors. These inherent differences led AcSEC to conclude that only vendor-specific evidence of fair value can be considered sufficiently objective to allow allocation of the revenue to the various elements of the arrangement.

102. AcSEC believes that the best evidence of fair value of an element is the price charged if that element is sold separately. However, an arrangement may include elements that are not yet being sold separately. As discussed in the previous paragraph, because of inherent differences between elements offered by different vendors, AcSEC concluded that companies should not use surrogate prices, such as competitor prices for similar products or industry averages, as evidence of fair value for such an element. However, AcSEC believes that if a price for the element has been established by management having the relevant authority, such a price represents fair value for

that element. To meet the criterion of objectivity, it must be probable that the established price will not change before the introduction of the element to the marketplace. Thus the internally established prices should be factual and not estimates. For this reason, AcSEC concluded that the allocations may not be adjusted subsequently.

103. AcSEC believes that if an undelivered element is essential to the functionality of a delivered element, the customer does not have full use of the delivered element. Consequently, AcSEC concluded that delivery is considered not to have occurred in such situations, and revenue should not be recognized until remaining undelivered elements are not essential to the functionality of delivered elements.

104. AcSEC believes that the earnings process with respect to delivered products is not complete if fees allocated to those products are subject to forfeiture, refund, or other concession if the vendor does not fulfill its delivery responsibilities. AcSEC believes that the potential concessions indicate the customer would not have licensed the delivered products without also licensing the undelivered products. Accordingly, AcSEC concluded that in order to recognize revenue, *persuasive evidence* should exist that fees allocated to delivered products are not subject to forfeiture, refund, or other concession. In determining the persuasiveness of the evidence, AcSEC believes that a vendor's history of regularly making concessions that were not required by the provisions of an arrangement is more persuasive than terms included in the arrangement that indicate that no concessions are required.

#### ***Delivery***

105. AcSEC believes that if the license fee is not based on the number of copies to be delivered to the customer, duplication of the software may be incidental to the arrangement. Paragraph 19 of this proposed SOP describes circumstances (arrangements where duplication is required only if additional copies are requested by customer; arrangements where the licensing fee is payable even if no additional copies are requested) that would lead to a conclusion that duplication is incidental to the arrangement. In other arrangements, vendors insist on duplicating the software to maintain quality control or to protect software transmitted by telecommunications. Others agree to duplicate the software as a matter of convenience to the customer.

106. In arrangements where duplication is considered incidental, AcSEC believes the vendor has fulfilled its delivery obligation once the first copy or product master of the software has been delivered. Therefore, AcSEC concluded that in such instances, the vendor should not be precluded from recognizing revenue if the customer has not requested additional copies (particularly since the fee is payable regardless of whether such additional copies are requested by the customer). However, the estimated costs of duplicating the software should be accrued when the revenue is recognized.

#### ***Fixed and Determinable Fees and Collectibility***

107. AcSEC believes that if the payment of a significant portion of the software licensing fee is not scheduled until more than twelve months after delivery, the fee may not be fixed or determinable. AcSEC believes that, given the susceptibility of software to significant external factors (namely, technological obsolescence), an arrangement with a relatively long period of scheduled payments indicates that vendor refunds or concessions may be more likely than in arrangements without such extended payment terms. Accordingly, AcSEC concluded that revenue generally should not be recognized upon delivery in arrangements with a significant portion of the fee scheduled more than twelve months after delivery. For example, if a vendor whose normal

credit terms are ninety days enters into an arrangement that calls for annual payments over the next three years, revenue should be recognized as each annual payment becomes due.

### ***Multiple-Element Arrangements***

#### ***Additional Software Deliverables and Right to Exchange or Return Software***

108. Upgrades/enhancements. In paragraph 36 of this proposed SOP, AcSEC concluded that the portion of the arrangement fee allocated to an upgrade right should be based on the price for the upgrade/enhancement that would be charged to existing users of the software product being updated. AcSEC believes that in arrangements that include upgrade rights, it may be difficult to determine which version of the software induced the customer to enter into the arrangement. For example, a customer licensing an existing version of the software may have done so to facilitate obtaining the updated version upon its introduction. To eliminate the possibility of allocating too much revenue to the delivered software (and thereby accelerating recognition), AcSEC concluded that the upgrade price should be used to determine the amount to be deferred. The residual amount, if any, is considered to be the fair value of the original product.

109. AcSEC believes that upgrades/enhancements do not necessarily contain improvements that customers would desire. A customer may not exercise an upgrade right for various reasons, including (1) the benefits to be gained from the related upgrade/enhancement may not be important to that customer, (2) the customer may not wish to learn new commands for what may be perceived by that customer as marginal improvements, or (3) the upgrade/enhancement would require more hardware functionality than the customer currently has. Consequently, AcSEC concluded that amounts allocated to upgrade rights should be reduced to reflect the percentage of customers that is not expected to exercise the upgrade right, based on vendor-specific evidence.

110. Additional Software Products. Often, multiple product arrangements are sold at a discount, rather than at the sum of the list prices for each product. If the amounts deferred for undelivered products were based on list prices, the amount of revenue recognized for delivered elements would be understated. Accordingly, AcSEC concluded that relative sales prices should be used in determining the amount of revenue to be allocated to the products of an arrangement.

111. As stated in paragraph 109 of this proposed SOP, AcSEC believes that not all customers entitled to an upgrade/enhancement will exercise their upgrade rights. However, AcSEC believes that it is probable that all customers will choose to receive additional software products. Consequently, AcSEC concluded that the fee allocated to additional software products should not be reduced by the percentage of customers not expected to exercise the right to receive the additional products.

112. Paragraphs 47 and 48 of this proposed SOP discuss accounting for software arrangements in which vendors agree to deliver unspecified additional software products in the future. AcSEC concluded that such arrangements should be accounted for as subscriptions, and that the fee from the arrangement should be recognized ratably as revenue over the term of the arrangement. AcSEC notes that, because the vendor is obligated to deliver these items only if they become available during the term of the arrangement, in some situations, delivery of additional products will not be required. AcSEC believes that because (a) the revenue-recognition conditions in paragraphs 7 through 12 of this proposed SOP are met and (b) the additional software products in fact may never be delivered, requiring deferral of all revenue until the end of the arrangement is too onerous. Accordingly, AcSEC concluded that revenue from the arrangement should be recognized ratably over the term of the arrangement.

113. *Rights to Exchange or Return Software*. AcSEC believes that rights to exchange or return software (including platform transfer rights) are subject to the provisions of FASB Statement No. 48, even though the software is not returned physically. Accordingly, AcSEC concluded that the accounting for exchanges of software for products with no more than minimal differences in price, functionality, and features by users qualify for exchange accounting because, as discussed in footnote 3 to FASB Statement No. 48, (a) users are “ultimate customers” and (b) exchanges of software with no more than minimal differences in price, functionality, and features represent “exchanges ... of one item for another of the same kind, quality, and price.” AcSEC concluded that because resellers are not “ultimate customers,” such exchanges by resellers should be considered returns.

114. AcSEC reached similar conclusions related to platform transfer rights. Additionally, AcSEC concluded that in situations in which customers are entitled to continue using the software that was originally delivered (in addition to the software that is to be delivered for the new platform), the customer has received additional software product, and the platform transfer right should be accounted for as such.

115. It is possible that exchange rights may be granted for software that has not been developed for other platforms at the time revenue from the arrangement is recorded. AcSEC did not address the issue as to whether such future development costs related to deliverable software for which no further revenue will be received should be capitalized pursuant to FASB Statement No. 86 because it was believed that such costs would not be significant. Accordingly, AcSEC concluded that in the event of significant development costs, it would not be likely to be able to persuasively demonstrate that the future software would have similar pricing, features, and functionality, and would be marketed as the same product (that is, qualify as an exchange for accounting purposes). In that event, the vendor has granted a return right that must be accounted for pursuant to FASB Statement No. 48.

#### *Postcontract Customer Support*

116. An obligation to perform PCS is incurred at the inception of a PCS arrangement and is discharged by delivering unspecified upgrades/enhancements, performing services, or both, over the period of the PCS arrangement. The obligation also may be discharged by the passage of time. AcSEC concluded that because estimating the timing of expenditures under a PCS arrangement usually is not practicable, revenue from PCS generally should be recognized in income on a straight-line basis over the period of the PCS arrangement. However, AcSEC also concluded that if there is sufficient vendor-specific historical evidence that costs to provide the support are incurred on other than a straight-line basis, the vendor should recognize revenue in proportion to the amounts expected to be charged to the PCS services rendered during the period.

117. SOP 91-1 required that revenue from both the PCS and the initial licensing fee be recognized ratably over the period of the PCS arrangement if no basis existed to derive separate prices for the PCS and the initial licensing fee. Diversity in practice arose as to what constituted a sufficient basis in arrangements involving vendors that did not sell PCS separately. In this proposed SOP, AcSEC has concluded that arrangement fees must be allocated to elements of the arrangement based on vendor-specific objective evidence of fair value. Because AcSEC determined that the evidence should be limited to that which is specific to the vendor, AcSEC believes that vendors that do not sell PCS separately have no basis on which to allocate fair values. AcSEC concluded that the total arrangement fee should be recognized in accordance with the provisions on recognition of PCS revenues. AcSEC also believes that, because a substantial portion of the arrangement fee typically is represented by the delivered software (rather than the performance of support), requiring deferral of all revenues until the PCS obligation is fully satisfied, would be too onerous. Accordingly,

AcSEC concluded that, as discussed in the previous paragraph, the total arrangement fee generally should be recognized ratably over the period of the PCS arrangement.

### *Services*

118. Certain software arrangements include both a software element and an obligation to perform non-PCS services. SOP 91-1 provided guidance on the conditions that must be met in order to account for the obligation to provide services separately from the software component. AcSEC is aware that this guidance has been interpreted in varying manners, leading to a diversity in practice. During its deliberations of this proposed SOP, AcSEC reached conclusions intended to clarify this issue, but did not redeliberate the other conclusions related to services that were included in SOP 91-1.

119. AcSEC believes that if (1) all other revenue allocation provisions of this proposed SOP are met; (2) the services are not essential to the functionality of any other element in the arrangement; and (3) the service and product elements are stated separately such that the total price of the arrangement would vary as a result of inclusion or exclusion of the services, the service element should be accounted for separately. Accordingly, AcSEC concluded that a service element need not be priced separately in an agreement in order to separately account for the services as a service transaction. AcSEC believes that this conclusion represents the original intent of SOP 91-1, and wishes to clarify the language at this time.

120. Paragraphs 121 to 124 of this proposed SOP are carried forward from SOP 91-1 with certain editorial changes.

121. *Service Elements*. Footnote 1 to paragraph 11 of SOP 81-1 excludes service transactions from the scope of the SOP, as follows:

This statement is not intended to apply to "service transactions" as defined in the FASB's October 23, 1978 Invitation to Comment, *Accounting for Certain Service Transactions*. However, it applies to separate contracts to provide services essential to the construction or production of tangible property, such as design . . . [and] engineering . . . .

122. The Invitation to Comment on service transactions, which was based on an AICPA-proposed SOP, was issued in 1978. The FASB later included service transactions as part of its project to develop general concepts for revenue recognition and measurement. The resulting FASB Concepts Statement No. 5, however, does not address service transactions in detail. Nevertheless, some of the concepts on service transactions developed in the Invitation to Comment are useful in accounting for certain software transactions.

123. A service transaction is defined in paragraphs 7 and 8 of the Invitation to Comment as

a transaction between a seller and a purchaser in which, for a mutually agreed price, the seller performs . . . an act or acts . . . that do not alone produce a tangible commodity or product as the principal intended result . . . A service transaction may involve a tangible product that is sold or consumed as an incidental part of the transaction or is clearly identifiable as secondary or subordinate to the rendering of the service.



The term *service transaction* is used in the same sense in this proposed SOP but, as used in this proposed SOP, does not apply to PCS. Items classified as tangible products in software service transactions generally should be limited to off-the-shelf software or hardware.

124. This proposed SOP, like the Invitation to Comment, recommends separation of such transactions with discrete elements into their product and service elements. Paragraph 8(b) of the Invitation to Comment states:

If the seller of a product offers a related service to purchasers of the product but separately states the service and product elements in such a manner that the total transaction price would vary as a result of the inclusion or exclusion of the service, the transaction consists of two components: a product transaction that should be accounted for separately as such and a service transaction . . . .

Revenue from the service element generally should be recognized as performed or, if no pattern of performance is discernible, ratably over the period during which the service is rendered, and revenue from the product element should be recognized in accordance with the revenue recognition provisions of this proposed SOP.

### ***Contract Accounting***

125. SOP 91-1 included guidance on the application of contract accounting to software transactions. Questions arose as to whether output measures could be used to measure progress-to-completion if the amounts recorded would differ from those that would have been reported had input measures been used. During its deliberations of this proposed SOP, AcSEC reached conclusions intended to clarify this issue, but did not redeliberate the other conclusions related to services that were included in SOP 91-1.

126. AcSEC believes that the method chosen to measure progress-to-completion on an individual element of a contract should be the method that best approximates progress-to-completion on that element. Accordingly, AcSEC concluded that output measures may be used to measure progress-to-completion, provided that use of output measures results in "the method that best approximates progress-to-completion."

127. Paragraphs 128 to 134 of this proposed SOP are carried forward from SOP 91-1 with certain editorial changes.

128. ARB No. 45 established the basic principles for measuring performance on contracts for the construction of facilities or the production of goods or the provision of related services with specifications provided by the customer. Those principles are supplemented by the guidance in SOP 81-1.

129. *Distinguishing Transactions Accounted for Using Contract Accounting From Product Sales.* SOP 81-1 suggests that transactions that are normally accounted for as product sales should not be accounted for using contract accounting merely to avoid the delivery requirements for revenue recognition normally associated with product sales. Paragraph 14 of SOP 81-1 states the following:

Contracts not covered . . . include . . . [s]ales by a manufacturer of goods produced in a standard manufacturing operation, even if produced to buyers' specifications, and sold in the ordinary course of business through the manufacturer's regular marketing channels if such sales are normally recognized as

revenue in accordance with the realization principle for sales of products and if their costs are accounted for in accordance with generally accepted principles of inventory costing.

130. Application of ARB No. 45 and SOP 81-1. SOP 81-1 provides guidance on the application of ARB No. 45 that applies to a broad range of contractual arrangements. Paragraph 1 of SOP 81-1 describes contracts that are similar in nature to software arrangements, and paragraph 13 includes the following kinds of contracts within the scope of that SOP:

- Contracts to design, develop, manufacture, or modify complex . . . electronic equipment to a buyer's specification or to provide services related to the performance of such contracts.
- Contracts for services performed by . . . engineers . . . or engineering design firms.

131. ARB No. 45 presumes that percentage-of-completion accounting should be used when the contractor is capable of making reasonable estimates. Paragraph 15 of ARB No. 45 states:

[I]n general when estimates of costs to complete and extent of progress toward completion of long-term contracts are reasonably dependable, the percentage-of-completion method is preferable. When lack of dependable estimates or inherent hazards cause forecasts to be doubtful, the completed-contract method is preferable.

Evidence to consider in assessing the presumption that the percentage-of-completion method of accounting should be used includes the technological risks and the reliability of cost estimates, as described in paragraphs 25, 26, 27, 32, and 33 of SOP 81-1.

132. Paragraph 24 of SOP 81-1 specifies a further presumption that a contractor is capable of making reasonable estimates and states the following:

[T]he presumption is that [entities] . . . have the ability to make estimates that are sufficiently dependable to justify the use of the percentage-of-completion method of accounting. Persuasive evidence to the contrary is necessary to overcome that presumption. [Footnote omitted.]

133. Although cost-to-cost measures may be verified easily, they tend to attribute excessive profit to the hardware elements of arrangements with combined software and hardware elements for contracts where segmentation is not permitted. Although the hardware elements of such arrangements have high cost bases, they generally yield relatively low profit margins to vendors. Furthermore, if excessive revenue is attributed to the hardware element, revenue recognition on the arrangement becomes overly dependent on when that element is included in the measurement of progress-to-completion.

134. For off-the-shelf software elements, application of the cost-to-cost method produces the opposite effect. The book basis of the software tends to be low, because most of the costs associated with software development frequently are charged to expense when incurred in conformity with FASB Statement No. 86. Although profit margins associated with software are generally higher than for other elements of the arrangement, application of cost-to-cost measures with a single profit margin for the entire arrangement would attribute little or no profit to the off-the-shelf software. Similarly, application of cost-to-cost to arrangements that include core

software, which also has a relatively low cost basis, would attribute a disproportionately small amount of profit to the software.

#### ***Effective Date and Transition***

135. The transition provisions of SOP 91-1 required retroactive restatement of financial statements of prior periods if the information for restatement was available. Because the changes required to adopt the provisions of SOP 91-1 were expected to result in significant changes in accounting, AcSEC was concerned at the time about the comparability of financial statements. AcSEC believes that changes required to adopt the provisions of this proposed SOP are not of the magnitude of those required to adopt SOP 91-1. AcSEC believes that the advantages of retroactive application in prior periods would not outweigh the disadvantages. Accordingly, AcSEC concluded that the cumulative effect of changes caused by adopting the provisions of this proposed SOP should be included in the determination of net income.

#### ***Items Not Retained from SOP 91-1***

136. AcSEC believes that the guidance included in SOP 91-1 related to discounting receivables and collectibility of receivables (discussed in paragraphs 56 and 78 of SOP 91-1, respectively) is not specific to the software industry, and thus does not need to be included in this proposed SOP.

## **APPENDIX A - EXAMPLES OF THE APPLICATION OF CERTAIN PROVISIONS OF THIS PROPOSED SOP**

### ***ADDITIONAL SOFTWARE PRODUCTS - PRICE PER COPY - EXAMPLE 1***

#### ***Facts***

A vendor enters into an arrangement under which a customer has the right to make copies of Product A at \$100 a copy, copies of Product B at \$200 a copy, or copies of Product C at \$50 a copy until such time as the customer has made copies aggregating \$100,000 based on the per copy prices. The customer is obligated to pay the \$100,000 whether or not the customer makes all the copies to which it is entitled under the arrangement. In all other respects, the \$100,000 is considered to meet the criteria of a "fixed fee," as described in this proposed SOP.

Master copies of products A and B are available currently and have been delivered. Product C is not available yet; therefore, no master copy has been delivered. The contract is clear that no portion of the fee attributable to copies made of products A and B is refundable if Product C is not delivered, nor is there any further obligation to deliver product C if copies of products A and B aggregating \$100,000 have been made. The per copy prices included in the arrangement for Products A and B are the per copy prices included in the company's price list, and the company has already approved the per copy price list for Product C to be \$50 per copy. Product C is not essential to the functionality of Products A or B.

The maximum number of copies of Product C that can be made is 500.

#### ***Accounting***

The vendor should allocate \$25,000 of the arrangement fee to Product C. The remaining \$75,000 of revenue should be recognized when the master copies of Products A and B are delivered to the customer. The \$25,000 allocated to Product C would be recognized when the master copy of Product C is delivered to the customer. If the customer duplicates enough copies of Products A and B so that the revenue attributable to those products exceeds \$75,000, the additional revenue should be recognized as the additional copies are made.

#### ***Discussion***

As discussed in paragraph 42 of this proposed SOP, in an arrangement in which a number of products are not deliverable or specified at the inception of the arrangement, an allocation of the arrangement fee generally cannot be made, because the total revenue attributable to each software product is unknown and depends on choices to be made by the customer and, sometimes, future development activity. However, as discussed in paragraph 45 of this proposed SOP, if such an arrangement specifies a maximum number of copies of the undeliverable or unspecified product, a portion of the arrangement fee should be allocated to the undeliverable product(s). This allocation should be made assuming the customer elects to receive the maximum number of copies of the undeliverable product(s).

Because the arrangement states a maximum number of copies of Product C that can be made, a basis for allocating the fair value to each product of the arrangement exists. The amount allocated to the undelivered product is the maximum amount that can be attributable to that product, based on the maximum number of copies of Product C that can be made (500) and the fee per copy (\$50). Accordingly, \$25,000 should be allocated to Product C and deferred until delivery of the product master. Because all other conditions for revenue recognition in this proposed SOP have

been met, revenue related to Products A and B may be recognized upon delivery of the masters of those products as discussed in paragraph 43 of this proposed SOP.

#### ***ADDITIONAL SOFTWARE PRODUCTS - PRICE PER COPY - EXAMPLE 2***

##### ***Facts***

Assume the same facts as above, except the arrangement does not state a maximum number of copies of Product C that can be made.

##### ***Accounting***

Revenue should be recognized as copies of Products A (\$100 of revenue per copy) and B (\$200 of revenue per copy) are made, until the master of Product C is delivered to the customer. Any remaining revenue should be recognized upon delivery of the master of Product C.

##### ***Discussion***

As discussed in paragraph 42 of this proposed SOP, although the fee per copy is fixed at the inception of the arrangement and the cost of duplication is incidental, the total fee allocated to the undelivered software (Product C) is unknown and will depend on the choices made by the customers as to how many copies of each product will be utilized.

#### ***AUTHORIZATION CODES - EXAMPLE 1***

##### ***Facts***

A vendor includes ten optional functions on a compact disk (CD-ROM) on which its software product is licensed. Access to those optional functions is not available without a permanent key. Users can order the optional functions and receive permanent keys to enable full use of those functions.

##### ***Revenue Recognition***

Revenue for each individual optional function should be recognized by the vendor when the user purchases it by placing an order, evidence of such order exists, and the key is delivered to the user.

##### ***Discussion***

Although the user has received a fully functional version (except for the keys) of the optional functions on the CD-ROM, the user has not agreed to license them. Because no evidence of an arrangement exists (as discussed in paragraphs 13 to 15 of this proposed SOP), revenue for the optional functions may not be recognized when the CD-ROM is delivered.

## ***AUTHORIZATION CODES - EXAMPLE 2***

### ***Facts***

A software vendor's products run on two different levels of central processing units (CPU) of the same manufacturer — Model X and Model Y (both of which are on the same platform). The vendor enters into a license arrangement with a user whereby the user licenses the vendor's products to run on the Model X but allows the user to move to Model Y at no additional charge. The vendor delivers the product in the form of a disk pack along with a CPU authorization code. At the time the user chooses to move to Model Y, the user does not receive a new disk pack; rather the vendor gives the user a new CPU authorization code.

### ***Revenue Recognition***

Revenue should be recognized on the delivery of the disk pack.

### ***Discussion***

Delivery of the authorization code to move to another CPU is not considered to be an additional software deliverable.

## ***MULTIPLE ELEMENT ARRANGEMENTS - EXAMPLE 1***

### ***Facts***

A vendor licenses a user one license covering a single copy of products A, B, C, and D for a nonrefundable fixed fee of \$80, with no stated price per product. Products A, B, and C are deliverable. Product D is not deliverable and is not essential to the functionality of products A, B, or C. Persuasive evidence exists that indicates the revenue related to products A, B, or C is not subject to refund, forfeiture or other concessions if product D is not delivered. The vendor has a history of sales prices for products A, B, and C of \$25 each. The vendor's pricing committee has established a price for product D of \$25. It is probable that the price established by the pricing committee for product D will not change before introduction. Therefore, the vendor is able to derive its specific price for the undelivered software.

### ***Revenue Recognition***

Revenue allocated to each product based on the existing prices for products A, B, and C and the probable price for product D should be recognized when each individual product is delivered. The revenue allocated to each of the products would be \$20.

### ***Discussion***

Revenue allocated to each product should be recognized upon delivery of that product if the criteria in paragraphs 7 through 12 of this proposed SOP have been met.

The allocation of revenue to each product is based on the relative fair value of each product. As discussed in paragraph 9 of this proposed SOP, sufficient vendor-specific objective evidence must exist to determine allocation. In this example, sufficient vendor-specific objective evidence exists to determine that the fair value of each product on a stand-alone basis is \$25. Therefore, in accordance with paragraph 40 of this proposed SOP, the discount should be allocated evenly to

each product, and revenue of \$20 per product should be recognized when each product is delivered.

### ***MULTIPLE ELEMENT ARRANGEMENTS - EXAMPLE 2***

#### ***Facts***

The transaction is the same as that outlined in the first example. The contract is silent about penalties for nondelivery of product D, but the proposal and other communications indicate that it is a required capability of the offering and that the user does not want any of the vendor's products unless product D is delivered.

#### ***Revenue Recognition***

All revenue must be deferred until delivery of product D.

#### ***Discussion***

Because revenue attributable to the delivered software is subject to forfeiture, refund, or other concession if product D is not delivered, all revenue under the agreement should be deferred until product D is delivered, in accordance with paragraph 11 of this proposed SOP.

### ***MULTIPLE ELEMENT ARRANGEMENTS - EXAMPLE 3***

#### ***Facts***

A vendor licenses 100 copies of version 1.0 of a software product for \$300 per copy with a right to receive version 2.0 at no additional cost when it becomes available. It is probable that the price will not change before introduction of version 2.0 into the marketplace. However, the pricing committee has not yet decided whether version 2.0 will be offered as an upgrade/enhancement to users of version 1.0 for \$100 or exclusively as a new product for \$300.

#### ***Revenue Recognition***

All revenue should be deferred until the pricing committee makes its decision and it is probable that the price established will be the price charged upon introduction.

#### ***Discussion***

Because the pricing committee has not yet decided whether version 2.0 will be offered as an upgrade/enhancement at \$100 or as a new product at \$300, sufficient vendor-specific objective evidence does not yet exist supporting the price of the undelivered software. As discussed in paragraph 10 of this proposed SOP, if sufficient vendor-specific objective evidence does not exist to determine allocation of revenue, all revenue from the arrangement should be deferred until sufficient vendor-specific objective evidence exists.

## ***MULTIPLE ELEMENT ARRANGEMENTS - EXAMPLE 4***

### ***Facts***

In the example above, assume the pricing committee determines that version 2.0 will be offered as an upgrade/enhancement. The pricing committee establishes a price of \$100 for version 2.0; it is probable that such price will not change prior to its introduction; and persuasive evidence exists indicating that the amount allocated to version 1.0 will not be subject to forfeiture, refund, or other concession. Also, the vendor's experience indicates that 40 percent of customers do not exercise upgrade rights.

### ***Revenue Recognition***

The vendor should defer \$6,000 (upgrade price of \$100 multiplied by 100 copies, reduced by 40 percent of customers not expected to exercise the upgrade right) until delivery of the upgrade and recognize the remaining \$24,000 on delivery of version 1.0.

### ***Discussion***

The portion of the arrangement fee allocated to the upgrade right is equal to the price for the upgrade determined pursuant to paragraph 36 of this proposed SOP. This amount should be deferred and recognized on the delivery of version 2.0. The amount deferred for the specific upgrade/enhancement should be reduced to reflect the percentage of customers that, based on experience, are not expected to exercise the upgrade right (see paragraph 36 of this proposed SOP). Accordingly, the \$10,000 revenue allocated to the upgrade right should be reduced by \$4,000 (40 percent of the allocated revenue).

If the vendor did not have experience indicating the percentage of customers that do not exercise the upgrade right, the vendor should defer the entire \$100 of revenue allocated to the upgrade right, under the assumption that, absent vendor-specific objective evidence to the contrary, 100 percent of customers will exercise the upgrade right.

If the pricing committee had decided to offer version 2.0 as a new product, rather than a specified upgrade/enhancement, and established a price of \$300, then the vendor should continue to defer the entire license fee and recognize \$30,000 upon delivery of the new product.

## ***SERVICE TRANSACTIONS - EXAMPLE 1***

### ***Facts***

A vendor has entered into an arrangement to provide a customer with its off-the-shelf software product and related implementation services. The software and service elements of the contract are stated separately and the company has a history of selling these services separately such that the revenue allocation criteria of paragraphs 7 to 12 of this proposed SOP can be satisfied. The software license fees are due under the company's normal trade terms, which are net 30 days. The services are expected to be provided over the next 90 days and are of the type performed routinely by the vendor. The features and functionality of the software are not altered to more than a minor degree as a result of these services.



### ***Revenue Recognition***

The vendor should recognize the license revenue allocated to the software element upon its delivery and the revenue allocated to the service element as such services are performed.

### ***Discussion***

When license arrangements have multiple elements, revenue should be allocated to each of the elements and recognized when the related element is delivered if

1. The undelivered elements are not essential to the functionality of the delivered elements
2. The revenue allocated to the delivered elements is not subject to forfeiture, refund, or other concession if the undelivered elements are not delivered
3. Sufficient company-specific objective evidence exists to allocate separate prices to each of the elements.

The service element in this arrangement is not deemed to be essential to the functionality of the software element because the features and functionality of the software are not altered to more than a minor degree as a result of the services.

### ***SERVICE TRANSACTIONS - EXAMPLE 2***

#### ***Facts***

Assume the same transaction as described above except the vendor agrees to make more than minor modifications to the functionality of the product to meet needs as defined by the user. Payment terms are 10 percent upon installation of the software, with the remainder according to a time line, and the final 25 percent withheld until acceptance. The desired modifications are not unusual; the vendor has made similar modifications to the product many times and is certain the planned modifications will meet the user's needs.

### ***Revenue Recognition***

This arrangement should be accounted for pursuant to the guidance on contract accounting (using either the percentage-of-completion or completed-contract method, depending on the facts and circumstances) included in paragraphs 75 to 92 of this proposed SOP.

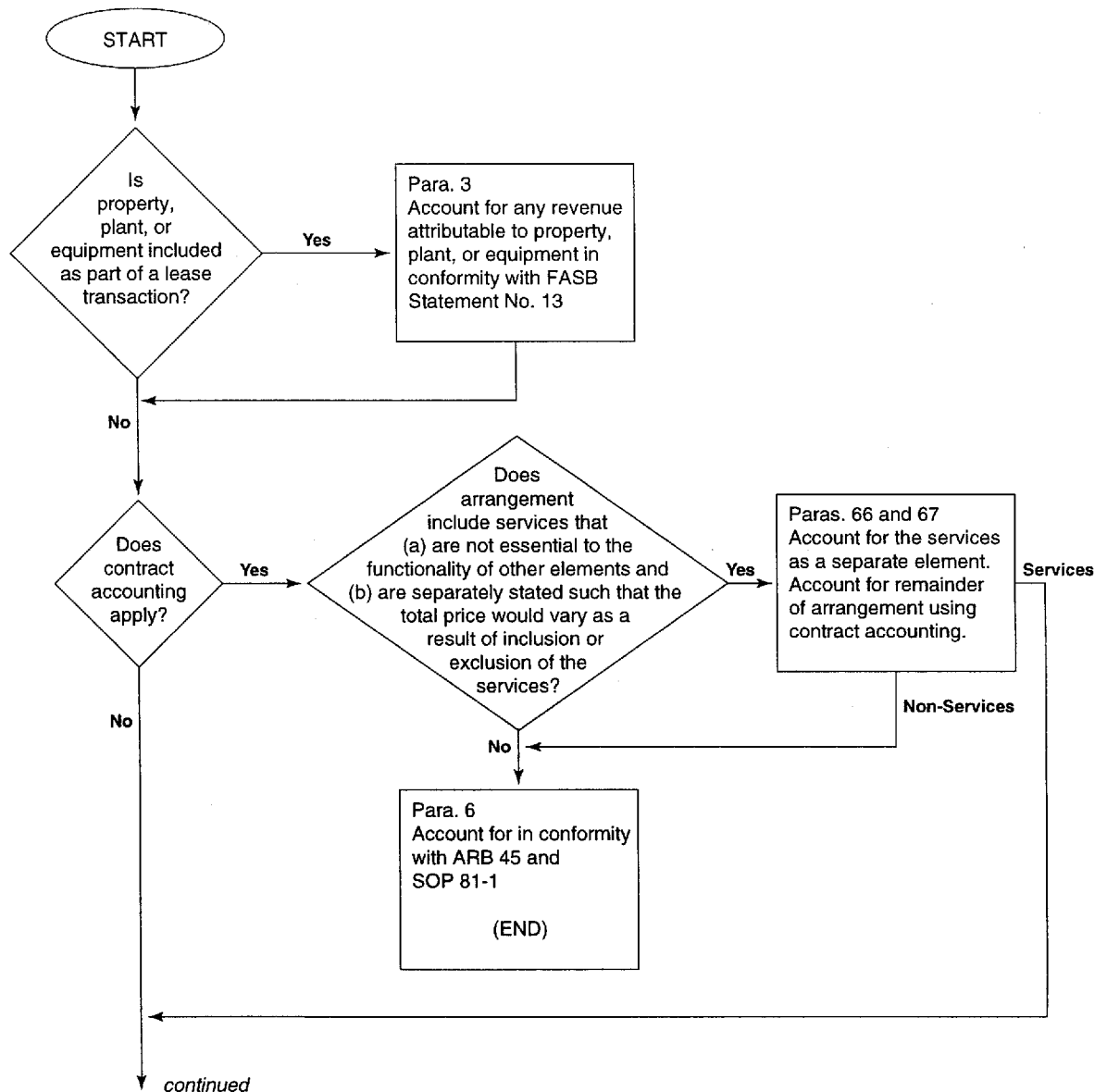
### ***Discussion***

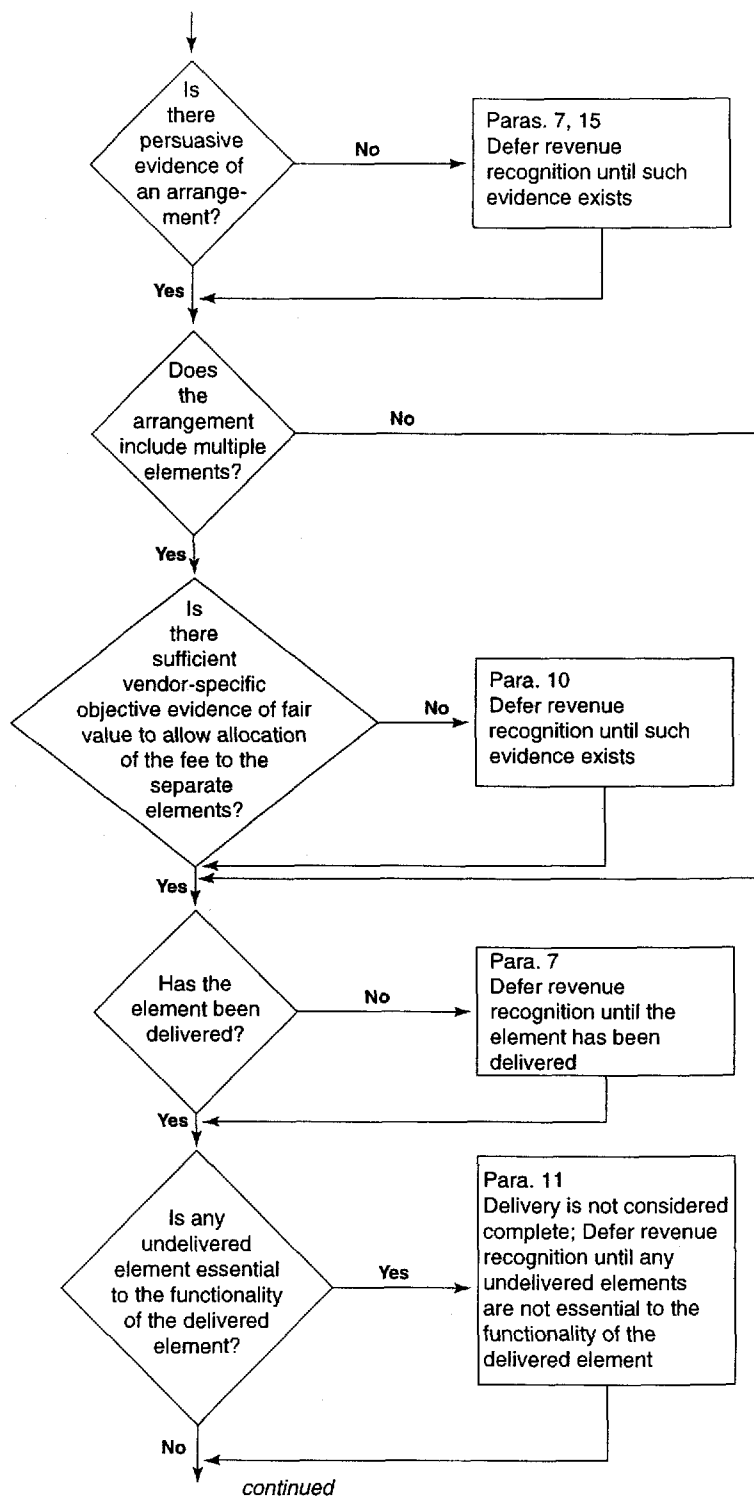
The new conditions would preclude service transaction accounting because the functionality of the software product is being altered in more than a minor way, payment of the license fees are coincident with the services being performed, and the software is subject to the user's unique acceptance criteria.

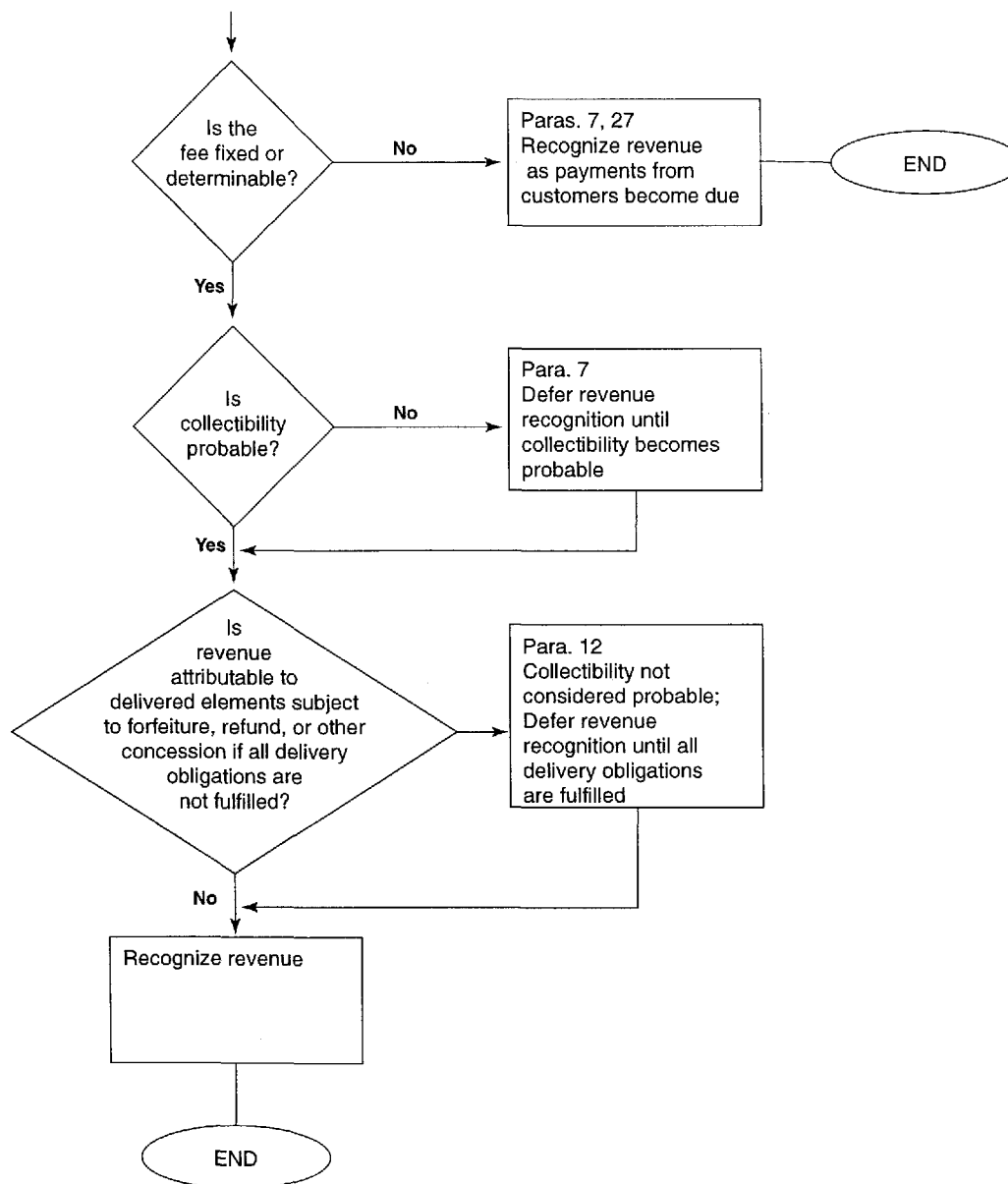
## APPENDIX B - FLOWCHART

### Revenue Recognition on Software Arrangements

The following flowchart illustrates a decision process for recognizing revenue on software arrangements. The flowchart is intended to illustrate the basic principle of revenue recognition and does not address the differences in accounting depending upon the type of element (services, upgrade rights, additional software products, or postcontract customer support) included in the arrangement. The flowchart summarizes certain guidance in this proposed SOP and is not intended as a substitute for the SOP.







## GLOSSARY

**Authorization Codes (keys).** A vehicle used by vendors to permit customers access to, use of, or duplication of, software that would otherwise be restricted.

**Core software.** An inventory of software that vendors use in creating other software. Core software is not delivered as is because customers cannot use it unless it is customized to meet system objectives or customer specifications.

**Customer.** A user or reseller.

**Delivery.** A transfer of software accompanied by documentation to the customer. It may be by —

- a. A physical transfer of tape, disk, integrated circuit, or other medium
- b. Transmission by telecommunications
- c. Making available to the customer software that will not be physically transferred, such as through the facilities of a computer service bureau
- d. Authorization for duplication of existing copies in the customer's possession

If a licensing agreement provides a customer with the right to multiple copies of a software product in exchange for a fixed fee, delivery means transfer of the product master, or the first copy if the product master is not to be transferred.

**Fixed fee.** A fee required to be paid at a set amount that is not subject to refund or adjustment. A fixed fee includes amounts designated as minimum royalties.

**Licensing.** Granting the right to use, but not to own, software through leases or licenses.

**Milestone.** A task associated with long-term contracts that, when completed, provides management with a reliable indicator of progress-to-completion on those contracts.

**Off-the-shelf software.** Software marketed as a stock item that customers can use with little or no customization.

**Platform.** The hardware architecture of a particular model or family of computers, the system software, such as the operating system, or both.

**Platform-transfer right.** A right granted by a vendor to transfer software from one hardware platform or operating system to one or more other hardware platforms or operating systems.

**Postcontract customer support (PCS).** The right to receive services (other than those separately accounted for as described in paragraphs 66 to 67 of this proposed SOP) or unspecified product upgrades/enhancements, or both, offered to users or resellers, after the software license period begins, or after another point in time as provided for by the PCS arrangement. Unspecified upgrades/enhancements are PCS only if they are offered on a when-and-if-available basis. PCS does not include the following:

- Installation or other services directly related to the initial license of the software
- Upgrade rights as defined in this proposed SOP
- Rights to additional software products

PCS may be included in the license fee or offered separately.

PCS is generally referred to in the software industry as maintenance, a term that is defined, as follows, in paragraph 52 of FASB Statement No. 86:

Activities undertaken after the product is available for general release to customers to correct errors or keep the product updated with current information. Those activities include routine changes and additions.

However, the term *maintenance* is not used in this proposed SOP for the following reasons.

1. It has taken on a broader meaning in the industry than the one described in FASB Statement No. 86.
2. It may be confused with hardware maintenance as it is used elsewhere in accounting literature
3. Its meaning varies from company to company.

The right to receive services and unspecified upgrades/enhancements provided under PCS is generally described by the PCS arrangement. Typical arrangements include services, such as telephone support and correction of errors (bug fixing or debugging), and unspecified product upgrades/enhancements developed by the vendor during the period in which the PCS is provided. PCS arrangements include patterns of providing services or unspecified upgrades/enhancements to users or resellers, although the arrangements may not be evidenced by a written contract signed by the vendor and the customer.

**Reseller.** Entity licensed by a software vendor to market the vendor's software to users or other resellers. Licensing agreements with resellers typically include arrangements to sublicense, reproduce, or distribute software. Resellers may be distributors of software, hardware, or turnkey systems, or they may be other entities that include software with the products or services they sell.

**Site license.** A license that permits a customer to use either specified or unlimited numbers of copies of a software product either throughout a company or at a specified location.

**Upgrade/Enhancement.** The terms upgrade and enhancement are used interchangeably to describe improvements to software products; however, in different segments of the software industry, those terms may connote different levels of packaging or improvements. This definition does not include platform-transfer rights.

**Upgrade right.** The right to receive one or more specific upgrades/enhancements. The upgrade right may be evidenced by a specific agreement, commitment, or the vendor's established practice.

**User.** Party that ultimately uses the software in an application.

**When-and-if-available.** An arrangement whereby a vendor agrees to deliver software only when or if it becomes deliverable while the arrangement is in effect. When-and-if-available is an industry term that is commonly used to describe a broad range of contractual commitments. The use of the term when-and-if-available within an arrangement should not lead to a presumption that an obligation does not exist.